Internal Revenue Service

memorandum

CC:INTL:454-88
Br1:WEWilliams

date: AUG 25 1988

to: Chief, Appeals Office, Denver
Attn: Mr. Roger Schneider

from: Senior Technician Reviewer, Branch No. 1
Associate Chief Counsel (International) CC:INTL:1

subject: Request for Informal Technical Advice [redacted]

This responds to your memorandum dated July 5, 1988, in which you ask, at taxpayer's request, for informal technical advice concerning an issue in this case.

The facts, taken from Exhibit A to taxpayer's letter dated [redacted], are generally as follows. Taxpayer, [redacted], is on the accrual basis of accounting. Taxpayer is in the business of developing and selling computer graphics systems. The issue relates to a Canadian corporation, [redacted] ("[redacted]") in which, for the years in issue, [redacted] and [redacted], taxpayer held a [redacted] percent interest, and to [redacted] European subsidiaries of taxpayer.

Before [redacted], taxpayer sold its computer systems to [redacted] which marketed them in Canada. By the end of [redacted], taxpayer had accumulated substantial accounts receivable from [redacted]. On [redacted], taxpayer received a demand promissory note from [redacted] for the principal amount of the accounts payable to taxpayer. The note bore interest at the prime rate then in effect as announced by the [redacted]. Also on [redacted], taxpayer acquired [redacted] percent of the stock of [redacted] and an option to purchase the remaining [redacted] percent. Taxpayer alleges that [redacted] was insolvent during [redacted] and [redacted], that its liabilities exceeded its assets, and that it was unable to pay its debts as they became due. Taxpayer also asserts that [redacted] incurred losses in [redacted] and [redacted]. Taxpayer forgave the interest on the note payable through [redacted] on [redacted]; and the interest on the note payable through [redacted] on [redacted]. The note principal was never paid and was converted into equity in [redacted] in [redacted].

Taxpayer marketed its computer systems in Europe through French, Italian, and German subsidiaries, i.e., [redacted], respectively. By the end of [redacted], these

subsidiaries owed taxpayer substantial accounts payable. No interest was stated in the accounts payable, because it was originally expected that the accounts would be paid within six months of their being incurred. Taxpayer alleges that the liabilities exceeded the assets of the [redacted] subsidiaries during [redacted] and [redacted] and that the subsidiaries incurred substantial losses in [redacted]. In [redacted], taxpayer converted the accounts receivable into equity interests in the [redacted] subsidiaries.

The IRS proposes to allocate to taxpayer, under I.R.C. § 482, income in amounts representing arm's length rates of interest on the notes payable to taxpayer by [redacted] and the [redacted] European subsidiaries. For purposes of your request for informal technical advice, it is assumed that the control requirements of section 482 are satisfied and that the amount of interest income has been correctly computed. The issue is whether, assuming that the debtors are insolvent, taxpayer is required to accrue interest income on indebtedness of a related borrower, as a result of the section 482 allocation, in situations where an unrelated creditor would not be required to accrue interest income because of the insolvency of the debtor.

Section 482 provides as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Section 1.482-1(a)(6) of the Treasury Regulations provides that the term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or any element affecting taxable income) that would have resulted to the controlled taxpayer had it dealt with the other member or members of the controlled group at arm's length. The term does not mean income resulting to the controlled taxpayer under an arrangement entered into by the taxpayer even though the arrangement is legally binding upon the parties thereto.

Section 1.482-1(b)(1) of the Regulations states that the purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining,

according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer, and the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Under section 1.482-1(c) of the Regulations, transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. Moreover, the authority to determine true taxable income extends to any case in which the taxable income of a controlled taxpayer is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Section 1.482-1(d)(4) of the Regulations provides that a section 482 allocation may be made to reflect true taxable income even though "the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period." As an example, the Regulation states:

> ...[I]f one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members.

The question in this case is essentially whether section 1.482-1(d)(4) of the Regulations permits the IRS to make an interest income allocation to an accrual basis taxpayer, under the circumstances of this case, where a party dealing at arm's length would not have been required to accrue the interest income from an unrelated debtor.

Section 1.482-1(d)(4) of the Regulations was adopted in 1968 in T.D. 6952, 1968-1 C.B. 218. The Regulation was in part a reaction to the so-called "creation of income" line of cases. For example, in Huber Homes, Inc. v. Commissioner, 55 T.C. 598 (1971), the parent corporation was engaged in the construction and sale of single-family homes. During 1965, the parent transferred 52 of its houses held for sale to a subsidiary

engaged in the rental of real property, since taxpayer was unable to sell the houses at the price for which they were being offered. The 52 houses were transferred to the subsidiary by journal entry at taxpayer's cost. The transferee-subsidiary planned no resale of the houses to any independent third-party and did not in fact resell any of the houses. The IRS argued that the difference between taxpayer's cost and an arm's length price for the houses should be allocated to the parent from its subsidiary under section 482. The Tax Court held that the Commissioner was attempting to create income rather than allocate income under section 482. The controlling factor, the court said, was that as the subsidiary did not resell the houses transferred to it, no income was actually realized that was in fact attributable to the parent corporation but which was artificially channeled to the subsidiary by means of an inter-company sale at cost. In other words, it was, in the court's view, an abuse of the Commissioner's discretion under section 482 to create income, i.e., to charge the parent corporation with the income it would have realized had its sale to its subsidiary been at arm's length.

Many of the cases which examined whether the section 482 allocation reflected income actually realized by the controlled entity dealt with interest-free loans. See Smith-Bridgman & Co. v. Commissioner, 16 T.C. 287 (1951), acq. 1951-1 C.B. 3; B. Forman Co. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972), aff'g. and rev'g. 54 T.C. 912 (1970), nonacq. 1975-1 C.B. 2, cert. denied 407 U.S. 934 (1971); PPG Industries, Inc. v. Commissioner, 55 T.C. 928 (1970); Kerry Investment Co. v. Commissioner, 500 F.2d 108 (9th Cir. 1974), aff'g and rev'g 58 T.C. 479 (1972); Kahler Corp. v. Commissioner, 486 F.2d 1, rev'g. and rem'g. 58 T.C. 496 (1972), nonacq. 1972-2 C.B. 3; Fitzgerald Motors Corp. v. Commissioner, 60 T.C. 957 (1975), aff'd 508 F.2d 1096 (5th Cir. 1975). In these cases, the Tax Court held that the Commissioner did not have legal authority under section 482 to allocate interest to the creditor with respect to loans the proceeds of which the IRS did not show produced gross income. It was this tracing requirement that section 1.482-1(d)(4) of the Regulations was intended to eliminate.

In Latham Park Manor, Inc. v. Commissioner, 69 T.C. 199 (1977), aff'd 618 F.2d 100 (4th Cir. 1980), the Tax Court rejected its creation of income position with respect to income allocations in the context of interest-free loans. In doing so, the court placed strong reliance on sections 1.482-1(d)(4) and 1.482-2 of the regulations. The court commented, at pages 215-216, as follows:

> Petitioners ask us to reject the teaching of these courts of appeals' opinions [the Second, Fifth, Eighth

> and Ninth Circuits] and base our conclusion on Smith-Bridgman & Co....; PPG Industries, Inc....; and this Court's opinions in Kerry Investment Co...., and Kahler Corp...., all involving loans at less than arm's-length rates. That line of cases enunciates the doctrine that section 482 may not be used to "create" income, i.e., no allocation may be made unless income was produced by the proceeds of the interest-free loan....But those Court opinions were written before sections 1.482-1(d)(4) and 1.482-2(a), Income Tax Regs...., or did not focus on such regulations. Those regulations are dispositive of the instant issue.
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> ...To the extent our conclusion herein is inconsistent with the opinions in Smith-Bridgman & Co....; PPG Industries, Inc....; Kerry Investment Co....; and Kahler Corp...., those opinions no longer will be followed.

Thus, there is substantial legal authority that the IRS may allocate interest income to the creditor in a controlled group setting, as in this case, without tracing the loan to the production of income by the debtor. In our view, it is this principle that section 1.482-1(d)(4) of the regulations is intended to illustrate.

We do not believe, however, that section 1.482-1(d)(4) of the regulations is intended to supersede rules such as, for example, the timing of income recognition by an accrual basis taxpayer. It is our view that the purpose of section 482 is to put two or more commonly controlled taxpayers on an arm's length basis. The question is whether an accrual taxpayer, once placed on an arm's length basis, may be required, under section 482, to recognize income that would not be recognized by an accrual basis taxpayer dealing at arm's length with an unrelated party. We think that the clear answer is that the IRS cannot require such recognition of income under the authority of section 482. That is, we agree with the taxpayer in this case that a creditor is not required, under section 482, to accrue interest income on indebtedness of a related borrower in situations where an unrelated creditor would not be required to accrue interest income because of the insolvency of the debtor.

The position that we are taking is the one adopted by the Tax Court in Johnson v. Commissioner, T.C. Memo. 1982-517, aff'd in an unpublished opinion, C.A. 3 (1984). In Johnson, Ocean Asphalt Co., Inc. loaned funds to Berkley Water, a water company regulated by the New Jersey State Public Utilities Commission; both Ocean Asphalt Co. and Berkley Water were effectively controlled by Robert Johnson. No interest was paid by Berkley Water, and the IRS, under section 482, allocated interest from Berkley Water to Ocean Asphalt Co. The

petitioner argued that no allocation could be made, since Berkley Water was losing money and "such interest was uncollectible." The Tax Court observed, at page 1083, that

> [u]nder the accrual method of accounting a taxpayer includes an income item in gross income when all the events have occurred to fix the right to receive such income and when the amount can be determined with reasonable accuracy.... However, if it is reasonably certain that the income will not be collected in the tax year or within a reasonable time thereafter, then a taxpayer is justified in not accruing the item. [Citation omitted.] This exception has typically been applied where the debtor is insolvent or in fact bankrupt, but the financial difficulty of the debtor alone does not constitute the requisite absence of reasonable expectancy of collection. [Citation omitted.]

In Johnson, the court determined that, on the particular facts, Ocean Asphalt Co. "had no reasonable expectancy of payment" and that it was not required to accrue the imputed interest in question.

The same issue was present in Cappuccilli, et al. v. Commissioner, T.C. Memo 1980-347, aff'd 668 F.2d 138 (2d Cir. 1981), a case relied on by the Tax Court in Johnson. In Cappuccilli, a partnership, CCP, a real estate development company, loaned money to two corporations controlled by the partners. No interest was paid on these loans, and the petitioners argued that the IRS was without authority to allocate interest to CCP, because "the financial status of ... [the two corporations] was such that, even if an adequate rate of interest had been charged (as presumably an unrelated third party would have done), such interest would not have been accruable, because there was no reasonable expectation of collection...." Cappuccilli, at page 1092. Based on an analysis of the abilities of the two corporations to pay interest to CCP, the court concluded that the petitioners did not carry their burden of proof on the issue of reasonable expectation of collectibility for purposes of accrual of the interest.

The issue of reasonable expectation of collectibility is one of fact. See, e.g., Chicago & North Western Railway Co. v. Commissioner, 29 T.C. 989, 996 (1958). According to your memorandum, you are not requesting advice as to whether taxpayer had a reasonable expectation of collecting the debts from [redacted] and the [redacted] European subsidiaries. This question will involve a detailed examination of the financial condition of each of the debtors. The issue under consideration is whether the IRS may require an accrual basis taxpayer to recognize income allocated to it under section 482

when the taxpayer has no reasonable expectation of collectibility. Because section 482 is intended to place two or more commonly-controlled organizations, trades, or businesses on an arm's length basis for the purpose of preventing the evasion of tax or to correctly reflect the income of the entities, whether an item of allocated income is accruable is determined under accrual accounting principles. If the income would not be accruable in a transaction between unrelated parties dealing at arm's length, we do not think that it would be accruable in the context of a section 482 allocation involving related parties. Accordingly, we do not think that the IRS, under section 482, may allocate interest income where there is no reasonable expectancy of collectibility.

If we can be of further assistance in this matter, please call Ed Williams at FTS 287-4851.

GEORGE M. SELLINGER